

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
T. H. RICHARDS, et al,)

Appearances:

For Appellantsa Malcolm S. Weintraub, Attorney at Law

For Respondent2 Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests against proposed assessments of additional personal income tax as follows:

<u>Appellants</u>	<u>Years</u>	<u>Amounts</u>
T. H. Richards	1951	\$1,608.10
Leona Richards	1951	1,608.10
T. H. Richards, Jr,	1951	60.84
Betty Richards	1951	60.84
Beverly Richards Fluornoy	1951	63.85
T. H. Richards, Jr., and		
Betty Richards	1952	64.18
"	1953	23.92
"	1954	46.46

T. H. and Leona Richards are the parents of T. H. Richards., Jr., and Beverly Richards Fluornoy, Betty Richards is the wife of T. H. Richards, Jr, The word "appellants" will hereafter refer to T. H. and Leona Richards only,

Appellants began raising Hereford cattle in 1941, Mr. Richards devoted full time to his job as an executive of a canning company of which he was a stockholder and financed the herd on his salary, dividends, and certain personal loans he was able to arrange with the company.

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Appellants' herd grew in size primarily due to the breeding of their own stock, although some additional animals were purchased. In 1946 appellants gave to their Son and his wife a one-half interest and to their daughter a one-half interest in 109 Hereford cattle. These animals were held under a partnership arrangement but appear to have been treated in the same manner as appellants' herd.

Appellants maintained high quality stock, considered to rank in the top 25 percent of California Hereford herds. This is evidenced by the numerous honors won by appellants' Prize animals during the years under review. A strict quality control program was followed under which animals were examined at birth, at ages 6, 12 and 18 months, and after the birth of their first offspring. Stock which displayed undesirable characteristics were culled out and sold for beef. Culling at age 12 months was particularly critical, for only then could appellants recover their approximate cost. The expense attributable to keeping an animal past that age quickly exceeded any increase in the animal's value as beef. After passing the first two examinations, the animals were registered with the American Hereford Association and a record was prepared showing the date of birth and lineage. These sheets also recorded successful breeding and any subsequent reclassification or sale. Appellants divided their stock into two separate herds, the "breeding" herd and the "commercial" herd. The latter consisted of inferior animals held for sale as beef. Further segregation within the breeding herd was also accomplished in order to properly control the breeding process. Certain animals of the breeding herd were kept on separate ranges and were not made available for inspection by prospective buyers.

Appellants acquired three ranches to accommodate their operations and at all times had sufficient facilities to satisfy the needs of their herd. Each year appellants set predetermined limits on the size of the herd. These limits depended upon the funds available to finance the operation. Appellants were able to borrow money from the canning company until 1950, when this source of credit was cut off and they were forced to turn to conventional lending institutions. This latter method of financing proved to be inadequate and appellants sold a large number of cattle in May 1950 and subsequent years in order to obtain the funds needed to maintain the herd. Due to the shortage of credit and rising costs of operation, increase in the size of appellants' herd was not considered feasible after 1950.

The numbers of breeding cattle held or sold by appellants were as follows:

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<u>Year</u>	<u>Mo. Sold</u>	<u>Ending Inventory 12/31</u>	<u>Percentage (No. Sold) (Ending Inv.)</u>
1944	12	519	3.2
1945	189*	456	41.04
1946	83	431	19.03
1947	80	619	12.9
1948	76	638	11.9
1949	44	804	5.05
1950	117	763	15.03
1951	140	682	20.5
1952	138	741	18.5
1953	163	765	21.3
1954	237	723	32.8

*Includes large sale of animals to
appellants' canning company,

In addition to selling their stock at various auctions throughout the year, appellants conducted an annual sale on Washington's birthday at Sacramento. These sales were advertised in a detailed catalog showing the lineage and breeding history of each animal offered for auction. In addition to the brochure, appellants regularly advertised in the American Hereford Journal. In 1951 they undertook a rather substantial advertising effort, expending about \$5,400.

When an animal passed the second culling, at age six months; it was considered by appellants to be a part of the breeding herd. During the years under review appellants reported gain derived from the sale of breeding herd stock held over 12 months as capital gain. Or. their return for 1951, the principal year involved, appellants reported the followingsales:

<u>Cattle:</u>	<u>Net Selling Price</u>
Held less than one year	\$ 3,334.48
Held one to two years	47,431.96
Held two to five years	26,244.10
Held five to ten years	3,556.42
Held over ten years	1,177.55
Total	<u>\$ 81,744.51</u>

The Franchise Tax Board determined that not all of appellants' breeding herd were held for breeding purposes, that some of them were held primarily for sale to customers and that those sales resulted in ordinary income rather than capital gains. Respondent disallowed capital gain treatment for all sales of heifers less than 26 months of age and of bulls less than 34 months of age.

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Sections 18181 and 18182 of the Revenue and Taxation Code (formerly sections 17722 and 17721) permit gain from the sale of property used in the trade or business to be considered gain from the sale of capital assets. The statutory definition of "property used in the trade or business" excludes "Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," and specifically includes "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition," (Rev. & Tax, Code, Par, 18182, subd. (a)(2) and (b)). These provisions are essentially the same as those found in section 1231 of the 1954 Internal Revenue Code and its predecessor, section 117(j) of the 1939 Code.,

The question before us turns upon the primary purpose for which the disputed livestock were held., (McDonald v. Commissioner, 214 F.2d 341; James M. McDonald, 23 T.C. 1091.) Whether an animal is held primarily for sale or for breeding purposes is a question of fact, (Biltmore Co. v. United States, 228 F.2d 9; L. D. Hancock, 31 T.C. 752; Gottfredson v. Commissioner 217 F.2d 673, cert. denied, 350 U.S. 846 [100 L. Ed. 753].) It is clear that an animal need not actually be used for breeding in order to meet the test laid down by the statute, (McDonald v. Commissioner, supra; M. P. Moore, 31 T.C. 735.) However, while actual use is not the sole determinant, it is the most persuasive evidence of the taxpayer's purpose in retaining certain animals. (John L. Clark, 27 T.C. 1006.) Appellants have the burden of demonstrating by convincing evidence that the disputed livestock were held for breeding purposes and something more than a mere declaration that they considered an animal to be a part of the breeding herd is required, (John L. Clark, supra.)

Appellants argue that they have proven that all of the animals in dispute were held for breeding purposes. We cannot agree. While the facts show that all of the animals held in appellants' "breeding herd" were of breeding quality, it is not established that they were all held primarily for use by appellants. The recording of lineage, etc., and registration with the American Hereford Association were equally necessary to the stile of these animals to purchasers seeking high quality stock for their own herds. The Franchise Tax Board's regulations make clear that an animal is not held for breeding purposes merely because it is suitable for such purpose or because it is held for sale to others for use by them for such purpose. (Cal. Admin. Code, tit. 18, Reg. 17721-17724, subd. (c); see also, Treas. Reg. Par. 1.1231-2 (1957) and William H. Schudel, T.C. Nemo, , Dkt. Nos. 59747, 60498, March 29, 1957,)

Appellants attempt to bring themselves within the holding of the McDonald cases. (McDonald v. Commissions, 214 F. 2d 341;

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James M. McDonald, 23 T.C. 1091,) both cases deal with the same Taxpayer, owner of an outstanding dairy and breeding herd of purebred Guernsey cattle, who was granted capital gain treatment in a situation somewhat similar to that presented here. An important dissimilarity, however, is the fact that taxpayer McDonald had set no predetermined limit on the size of his herd and only sold an animal if it failed to meet his high standards. He kept all animals that proved suitable and the herd increased, in size every year but two,

In contrast, appellants determined early in 1950 that further increase in the size of their breeding herd was not feasible. Indeed, the number of animals decreased from a high in early 1950 of 804, to 723 at the end of 1954. The number of sales increased sharply from 44 in 1949 to 117 in 1950, and thereafter continued to increase until 1954 when 237 animals were sold. It is clear that during the years under review appellants were not just culling inferior specimens from their herd. The criterion for sale was not solely qualitative. In any crop of yearlings, appellants knew that a given number of them would have to be sold, regardless of their quality, in order to avoid overstocking the herd. It was known that this surplus of animals or their equivalents would never be used by appellants for breeding purposes.

In view of the limits placed on the size of the breeding herd, appellants' need for cash to maintain it, the number of cattle sold, and the regularity and degree of sales effort, we find that appellants held some of their "breeding herd" primarily for sale to customers during the years under review. (See Biltmore Co. v. United States, 228 F.2d 9; Gotfredson v. Commissioner, 217 F.2d 673, cert. denied, 350 U.S. 846 / 100 L. Ed. 753 /; Cole v. United States, 138 F. Supp. 186; John L. Clark, 27 T.C. 1006.)

While the fact that buyers were not permitted complete freedom of choice among the herd members indicates that the animals held for sale were more readily identifiable than appellants admit, no evidence has been offered on which we can accurately determine which animals were, in fact, held for breeding purposes. The Tax Court, faced with a similar dilemma in Walter S. Fox, 16 T.C. 854, adopted a test based on the earliest average age at which any of the taxpayer's heifers dropped a calf or it could be determined that a bull possessed the necessary breeding characteristics. This test was approved by the United States Court of Appeals, Fourth Circuit, in Fox v. Commissioner, 198 F.2d 719. Similar tests have been approved in: Biltmore Co. v. United States, 228 F.2d 9; Gotfredson v. Commissioner, 217 F.2d 673, cert. denied, 350 U.S. 846 / 100 L. Ed. 753 /; Ralph Wadley, T.C. Memo., Dkt. No. 26694, Mov. 18, 1952; and A. Harold Schmidt, T.C. Memo., Dkt. Nos. 27355, 27356, May 31,

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1951, The Franchise Tax Board applied the Fox test in this case. Since appellants have not demonstrated that it is erroneous, respondent's action must be sustained,

The facts regarding animals owned by Betty and T. H. Richards, Jr., and Beverly Richards Fluornoy are essentially the same as those already established herein, and we therefore reach the same conclusions as to them.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on protests against proposed assessments of additional personal income tax as follows:

<u>Appellants</u>	<u>Years</u>	<u>Amounts</u>
T. H. Richards	1951	\$1,608.10
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Beverly Richards Fluornoy	1951	63.85
T. H. Richards, Jr., and		
Betty Richards	1952	64.18
"	1953	236.92
"	1954	46.46

be and the same is hereby sustained,

Done at Pasadena, California, this 26th day of November 1962, by the State Board of Equalization,

George R. Reilly, Chairman
Richard Nevins, Member
Paul R. Leake, Member
John W. Lynch, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary